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A Fear That the Cure Could Be Poison

By Edmund Andrews
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WASHINGTON — Even as the Federal Reserve grapples with the collapse of a speculative bubble in housing — the second speculative bust in less than a decade — is it at risk of repeating recent mistakes?

One day after the Fed slashed its benchmark interest rate to head off a possible recession, a small minority of economists warned on Wednesday that the central bank was in danger of invoking the same remedies that it did after the bubble in dot-com stocks burst seven years ago.

Though most experts agree that the economy is on the brink of a recession, and some even contend the recession has already begun, critics say the Fed's attempted rescue looks uncomfortably similar to the aggressive rate reductions that aggravated the speculative bubble in housing.

"We've literally forgotten that this is the very policy environment that led to the housing and mortgage problems in the first place," said Michael T. Darda, an economist at MKM Partners, an investment firm in Greenwich, Conn. "We're not going to see another housing bubble, but we could see more inflation."

Beyond the danger of higher inflation, some analysts warn that the Federal Reserve and its chairman, Ben S. Bernanke, could also lose credibility by appearing to act in knee-jerk response to plunging stock prices.

"They risk being seen as bailing out equity investors," wrote Adam S. Posen, deputy director of the Peterson Institute for International Economics in Washington. "It makes it look as though stock market fears are driving the Fed to action."

There are few signs yet of rising inflation, while the evidence is increasing that American economic growth has slowed to a crawl. Because a cooling economy usually damps inflation by reducing demand for goods and services, Fed officials are now far more worried about a painful slowdown than about inflation.

But other central banks are not following the Fed's lead. Jean-Claude Trichet, president of the European Central Bank, strongly hinted on Wednesday that European policy makers would keep their benchmark rate unchanged.

"Particularly in demanding times of significant market correction and turbulences, it is the responsibility of the central bank to solidly anchor inflation expectations to avoid additional volatility," Mr. Trichet told the European Parliament in Brussels. The Bank of England is not expected to reduce rates quickly either.

European central bankers face challenges that are different from those the Fed confronts. Few European countries have a housing collapse even remotely comparable to that in the United States, though many European banks are suffering big losses on their holdings of American mortgage-backed securities.

But Mr. Trichet's comments sent a chill through stock markets on both sides of the Atlantic on Wednesday. Stock prices in the United States endured another day of brutal swings, swooning badly in the morning and early afternoon and then skyrocketing back up at the end of the day. The Dow Jones industrial average closed up nearly 300 points.

For Mr. Bernanke, the biggest risk now is that financial markets will become paralyzed by fear and that investors, corporations and consumers will pull back on their investing and spending, setting in motion a spiral of economic decline.

Many economists argue that Fed policy makers were entirely justified in reducing the overnight Federal funds rate by three-quarters of a percentage point on Tuesday, to 3.5 percent, and investors are betting that the Fed will lower the short-term rate another half of a point at a policy meeting next week.

“Credit conditions have not gotten any easier,” said Robert J. Barbera, chief economist at ITG Hoenig, an economic forecasting firm. Because of the continuing anxiety about soured mortgages and the need for banks to keep large volumes of loans on their own balance sheets, Mr. Barbera said, the credit crisis is extending beyond subprime mortgages to many kinds of business borrowers.

But there are hints that the Fed’s rush to reduce interest rates has already had a slight impact on inflation expectations.

Mr. Bernanke and other Fed officials contend that inflation expectations are crucial to the actual course of inflation. Fed officials closely scrutinize two measures of popular expectations.

One, the University of Michigan’s monthly survey of consumers, offers reassuring evidence that consumers’ long-run expectations have not changed much, even though consumers do expect higher prices over the next year or two — a reflection of concern about higher energy prices.

The other measure is the difference between the prices of normal Treasury securities and an inflation-adjusted type, known as Treasury inflation-protected securities, or TIPS. The difference in prices is thought to reflect investors’ expectations about inflation.

Brian Sack, senior economist at Macroeconomic Advisers in Washington, said the premium on inflation-protected five-year Treasury securities widened slightly after the Fed announced its rate cut on Tuesday. The increase was small, to 2.52 percent from 2.47 percent, and Mr. Sack cautioned that it could simply reflect market noise. But he said the implicit inflation premium was at the upper range of its level in the past two years.

“One of the risks inherent in aggressive easing is the possibility of dislodging inflation expectations,” Mr. Sack said.

Mr. Posen of the Peterson economics institute predicted that the Fed’s new policy of lower interest rates would provide “too much rather than too little stimulus” and help push inflation noticeably higher in 2009 and 2010.

But Mr. Posen added that the Fed was facing undeniable pressures to act decisively against a potentially serious downturn.

Mr. Bernanke and other Fed officials are well aware of the risks, and of criticism by some experts that the Fed’s cheap-money policies from 2001 to 2004 may have aggravated the bubble in housing.

Indeed, Mr. Bernanke resisted demands from Wall Street to reduce interest rates faster. As recently as three weeks ago, the Federal Reserve’s official stance was that the risks of slowing growth were still roughly balanced against the risk of higher inflation.

If the Fed continues to lower interest rates, as many Wall Street analysts predict, Mr. Bernanke is nonetheless likely to absorb as many lessons as possible from its experience after the dot-com bubble burst.

Frederic S. Mishkin, a Fed governor with close ties to Mr. Bernanke, suggested in a speech in August what one of those lessons might be. If housing prices plunged, Mr. Mishkin said, the Fed should cut rates quickly and substantially. But once the economy begins to recover, he continued, the Fed should raise them back to normal almost as quickly.